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In the

Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1042

ERNST & ERNST,

Petitioner,

vs.

OLGA HOCHFELDER, ET AL.,

Respondents.

ERNST & ERNST,

Petitioner,

vs.

LEON S. MARTIN, ET AL.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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IN THE

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Petitioner, Ernst & Ernst, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit which entered an order on August 30, 1974 reversing summary judgment for the Petitioner.

OPINIONS BELOW

The opinion of the Court of Appeals reversing the decision of the District Court and remanding these cases for trial (Appendix A, *infra*, pp. 1a-34a) is reported at 503 F.2d 1100. The opinion of the District Court granting summary judgment for the Petitioner (Appendix B, *infra*, pp. 35a-40a) is unreported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 30, 1974, a timely petition for rehearing was denied on November 22, 1974 (Appendix C, *infra*, p. 41a) and this petition for a writ of certiorari was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Whether Respondents may predicate a cause of action against Petitioner for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5, on an allegation of negligence in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?

2. Whether the statute of limitations applicable to Respondents' cause of action against Petitioner may be tolled by Petitioner's alleged "negligent facilitation and implementation of fraud" in the absence of any allegation of deliberate or intentional fraud or reckless or willful conduct or of knowledge of such fraud or conduct on the part of Petitioner?

3. Whether Petitioner is entitled to a judgment as a matter of law (i) that Respondents failed to exercise due diligence in obtaining knowledge of the alleged fraud and therefore cannot depend on the doctrine of fraudulent concealment to toll the applicable statute of limitations and (ii) that Respondents' knowledge and conduct was such to cause their claims to be barred by the doctrine of equitable estoppel?

4. Whether Petitioner is entitled to a judgment as a matter of law that it exercised all due care and diligence in accordance with generally accepted auditing standards in conducting its audits of First Securities?

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5, are set forth in Appendix D, *infra*, p. 42a.

STATEMENT OF THE CASE

Petitioner, Ernst & Ernst, seeks review of the decision of the Court of Appeals which reversed summary judgment for Petitioner and remanded these consolidated cases for trial.

On February 19, 1971 and May 18, 1971, respectively, Respondents Olga Hochfelder et al. and Respondents Leon S. Martin et al. filed substantially identical complaints against Petitioner Ernst & Ernst and the Midwest Stock Exchange (the "Exchange") in the United States District Court for the Northern District of Illinois. Subsequently the cases were consolidated, and on October 12, 1971 Respondents jointly filed a First Amended Complaint in two counts. The First Count charged the Exchange with aiding and abetting an alleged fraud on

the Respondents perpetrated by Lester B. Nay ("Nay"), President of First Securities Company of Chicago ("First Securities"), whose conduct in connection with certain "escrow" transactions with Respondents was alleged to have been in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. §240.10b-5, thereunder.* The Second Count charged Petitioner Ernst & Ernst with aiding and abetting the same alleged fraud perpetrated by Nay. The basis for federal jurisdiction for both counts was Section 27 of the 1934 Act, 15 U.S.C. §78aa.

Respondents' claim against Petitioner Ernst & Ernst alleged as follows: Respondents, securities customers of First Securities, were persuaded by Nay to invest funds in certain "escrow" accounts, which funds Nay converted to his own use in violation of Section 10b and Rule 10b-5. Nay shot and killed himself in June 1968. His estate has no assets and First Securities is insolvent. Ernst & Ernst, a firm of certified public accountants which audited First Securities Company for several years prior to 1968, is charged with aiding and abetting Nay's fraud by negligently failing to exercise proper or appropriate auditing procedures which Respondents claim would have resulted in discovery of the fraud. This charge of negligence hinges on Ernst & Ernst's alleged failure to make adequate and proper inquiry which Respondents allege would have resulted in discovery of the facts that Nay took no regular vacations and did not permit anyone

* The Exchange answered the First Amended Complaint and filed a motion for summary judgment which was granted by the District Court on October 3, 1972 and affirmed by the Court of Appeals, *sub nom. Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir. 1974), *cert. denied*, ... U.S. ....., 42 L.Ed. 2d 114 (1974).

but himself to open his mail. Respondents submit that discovery of these facts should have caused Ernst & Ernst to conclude that First Securities lacked proper accounting controls. No allegation is made that Ernst & Ernst either participated in or had any actual knowledge of the alleged fraud perpetrated by Nay.

Ernst & Ernst answered the First Amended Complaint and on December 11, 1972 filed its motion for summary judgment which it supported by the pleadings, Respondents' answers and supplemental answers to Ernst & Ernst's interrogatories, Respondents' responses to the Exchange's request for admission of facts and genuineness of documents, the District Court's October 3, 1972 order granting summary judgment for the Exchange and the affidavits filed by the Exchange therewith. In addition, Ernst & Ernst filed in support of its motion the affidavits of the cashier and secretary of First Securities, of three certified public accountants with Ernst & Ernst, of the Assistant Director of the District No. 8 office of the National Association of Securities Dealers and of a certified public accountant with the accounting firm of Haskins & Sells.

In opposition to Ernst & Ernst's motion the Respondents filed the affidavits of two retired certified public accountants and the affidavit of a retired national bank examiner.

On August 1, 1972 the District Court granted Ernst & Ernst's motion for summary judgment. Although Ernst & Ernst argued vigorously before the District Court that it could not be charged with aiding and abetting Nay's fraud since it had no knowledge of and did not participate in or affirmatively aid such fraud, the District

Court noted that Ernst & Ernst "could be held liable on one or more legal theories for any negligence in auditing First Securities Company . . ." (Appendix B, *infra*, pp. 39a-40a). The District Court's decision granting summary judgment rested on the following three alternative grounds advanced by Ernst & Ernst:

1. That the applicable three year statute of limitations barred the Respondents' cause of action and was not tolled by the doctrine of fraudulent concealment since only Nay or First Securities and not Ernst & Ernst had fraudulently concealed the Respondents' cause of action and since the Respondents had allowed Nay to conduct and to conceal his illegal activities by paying for their investments in checks payable to Nay personally, by reporting to the Internal Revenue Service as late as 1965 that Nay was paying interest to them on their personal indebtedness and by inaccurately confirming their accounts when requested by Ernst & Ernst to verify them. (Appendix B, *infra*, p. 36a).

2. That the Respondents were estopped as a matter of law from bringing their cause of action against Ernst & Ernst since they had failed to report the escrow transactions to Ernst & Ernst when requested by Ernst & Ernst to confirm their accounts. (Appendix B, *infra*, p. 37a).

3. That Ernst & Ernst as a matter of law performed its auditing duties properly since its affidavits showed that Ernst & Ernst audited First Securities in accordance with generally accepted auditing practices, and since Respondents' affidavits failed to provide any competent evidence to the contrary. (Appendix B, *infra*, pp. 38a-39a).

On August 30, 1974 the Court of Appeals reversed summary judgment for Ernst & Ernst and remanded the cases to the District Court for trial. In so deciding, the Court of Appeals held:

1. That a cause of action for aiding and abetting solely by inaction may be maintained under Section 10(b) of the 1934 Act and Rule 10b-5 by a showing:

> that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure. (Appendix A, *infra*, p. 4a).

2. That the applicable three-year statute of limitations could be tolled by Ernst & Ernst's alleged "negligent facilitation and implementation of Nay's fraud" and that whether the Respondents "knew or in the exercise of due diligence should have known of Nay's fraud is . . . an issue properly to be decided at a trial." (Appendix A, *infra*, p. 34a).

3. That whether the Respondents "knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be properly decided by the fact finder." (Appendix A, *infra*, pp. 31a-32a).

4. That "(1) Whether Nay's mail rule constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether Ernst & Ernst failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control" (Appendix A, *infra*, p. 18a) are genuine issues of material fact to be properly decided at trial.

REASONS FOR GRANTING THE WRIT

I. THE DECISION BELOW CONFLICTS WITH THE DECISIONS OF OTHER COURTS OF APPEALS AS TO WHETHER A CAUSE OF ACTION FOR VIOLATIONS OF SECTION 10(b) OF THE 1934 ACT AND RULE 10b-5 THEREUNDER MAY BE PREDICATED ON NEGLIGENCE IN THE ABSENCE OF DELIBERATE OR INTENTIONAL FRAUD OR RECKLESS OR WILLFUL CONDUCT OR OF KNOWLEDGE OF SUCH FRAUD OR CONDUCT ON THE PART OF THE DEFENDANT.

The Court of Appeals notes specifically in its opinion that "(i)n the instant action plaintiffs claim that Ernst & Ernst was *negligent* in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation." (Appendix A, *infra*, p. 3a). (Emphasis added). Respondents have not charged that Ernst & Ernst engaged in any act of fraud; in fact, the Court of Appeals states that "admittedly, (Ernst & Ernst) had no *knowledge* of Nay's fraudulent escrow scheme." (Appendix A, *infra*, p. 4a). (Emphasis added). Relying on its opinion in *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir. 1974), *supra*, the Court of Appeals holds that a cause of action for aiding and abetting a violation of Rule 10b-5 may be predicated on "a breach of duty of inquiry" (*i.e.*, negligence)in the absence of any fraudulent activity or actual knowledge of fraudulent activity on the part of the defendant.* (Appendix A, *infra*, p. 4a).

* The instant cases and the companion cases *Hochfelder* v. *Midwest Stock Exchange, supra*, are the first decisions in the Seventh Circuit to hold that a cause of action for aiding and abetting a Rule 10b-5 violation may

In so holding, the Seventh Circuit, in accord with cases decided by the Ninth Circuit and *dicta* expressed by the Eighth Circuit, takes a position which is in sharp conflict with the holdings of the Courts of Appeals for the Second, Sixth and Tenth Circuits. The latter three Circuits have each held in recent opinions that mere negligence, absent the element of *scienter*, is insufficient to state a cause of action under Rule 10b-5.*

The Second Circuit in *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971), an action against a brokerage firm for losses allegedly arising out of the firm's failure to effect a prompt sell out of plaintiffs' account, noted that the plaintiffs' claim was nothing more than an action for breach of contract, not actionable under Section 10(b) and Rule 10b-5, ". . . in the absence of allegation of facts amounting to *scienter*, intent to

* (Continued)
be predicated solely on negligence in the absence of *scienter*. Earlier Seventh Circuit holdings required at the minimum negligent inaction coupled with knowledge of the alleged deceit. *See, Brennan* v. *Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), and *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 410 F.2d 135 (7th Cir. 1969), *cert. denied*, 396 U.S. 838 (1969).

* Some of the opinions from the Second, Sixth and Tenth Circuits cited below arise in a different posture from the instant cases in that they do not involve assertions of aiding and abetting, but of primary liability. However, the standard of proof necessary to establish liability for aiding and abetting should not be lower than that needed for the actual violation. If it were otherwise, the law would sanction the anomalous result that a showing of *scienter* would be necessary to render a principal in a fraudulent scheme liable, but that a showing of mere negligence would suffice in the case of an aider and abetter.

defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud. It is insufficient to allege mere negligence. . . ." 448 F.2d 442, 455.

Sitting *en banc* in *Lanza* v. *Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973), the Second Circuit dismissed a civil action brought by purchasers of stock under Rule 10b-5 against a corporate director for negligent failure to investigate false representations and omissions made by officers and other directors of the corporation. The defendant had neither participated in the negotiations leading to the sale of stock to the plaintiffs nor had he any actual knowledge that false representations and material omissions had been made. Focusing chiefly on the legislative and administrative history of Section 10(b) and Rule 10b-5 and the case law in the Second and other Circuits, the Court of Appeals affirmed the District Court's dismissal of the complaint against the director:

> Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants. 479 F.2d 1277, 1302.

The express language of Section 10(b), the Second Circuit continues, "bars adoption of a negligence standard." 479 F.2d 1277, 1305. The minimum standard of culpability required to establish liability under Rule 10b-5 is "willful or reckless disregard for the truth." 479 F.2d 1277, 1306.•

• *Lanza* v. *Drexel, supra,* and *Shemtob* v. *Shearson, Hammill & Co., supra,* have ended any doubt raised in the earlier Second Circuit decisions (*Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1290-1291 (2d Cir. 1970), *cert. denied,* 397 U.S. 913 (1970) and *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1966), *cert. denied,* 394 U.S. 976 (1969)) that an action under

In *S.E.C.* v. *Coffey,* 493 F.2d 1304 (6th Cir. 1974), *petition for cert. filed,* 43 U.S.L.W. 3331 (Nov. 27, 1974) (No. 660), an action for an injunction• brought by the Securities and Exchange Commission against a corporation and certain of its officers who had allegedly made false statements and omissions of material facts in connection with the sale of certain notes to the State of Ohio, the Sixth Circuit held that no injunction could issue against the chairman of the corporation as an aider and abetter, since there was no evidence that the chairman had knowledge of the fraud. The Sixth Circuit stated at 493 F.2d 1304, 1316:

> . . . we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party has general awareness that his role is part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation.

• (Continued)
Rule 10b-5 may be sustained on a charge of negligent conduct. Additional recent Second Circuit decisions with language to the effect that mere negligence is insufficient include *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 397 (2d Cir. 1973), *cert. denied,* 414 U.S. 910 and 414 U.S. 424 (1973); *Republic Technology Fund, Inc.* v. *Lionel Corp.*, 483 F.2d 540, 555 (2d Cir. 1973), *cert. denied* 414 U.S. 1133 (1974) and *Mariash* v. *Morrill,* 496 F.2d 1138, 1145 (2d Cir. 1974).

• This Court has indicated that the elements of culpability are less exacting in a Securities and Exchange Commission injunctive suit than in an action for private damages. *S.E.C.* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192 (1963). Therefore, it follows that if the Sixth Circuit requires the element of *scienter* in an injunctive suit, it will require a standard at least as exacting in an action for damages. *See also* the concurring opinion of Judge Friendly in *S.E.C.* v. *Texas Gulf Sulphur Co., supra,* at 866-868.

Inaction, the Sixth Circuit continues, may be a form of assistance, but only if "consciously intended to aid the securities violation" and if such conscious intent is proved by "reliable and probative evidence." 493 F.2d 1304, 1317.

The Tenth Circuit, in *Clegg* v. *Conk*, ... F.2d ....., 1973-1974 CCH Fed. Sec. L. Rep. ¶94,897 (10th Cir. 1974), a case seeking damages under Section 10(b) and Rule 10b-5 and other provisions of federal and state law allegedly caused by certain untrue material statements and omissions to state facts relating to the sale of interests in a car washing business, ruled that the trial court erred in omitting the element of *scienter* from its charge to the jury, stating: ". . . there is required something additional by way of scienter or conscious fault than mere negligence . . . this court has repeatedly declined to extend the acts to cases of simple negligence not involving some fraudulent purpose or species of scienter within their scope and purpose."*

In the Eighth Circuit *dicta* in certain decisions indicate that this Circuit would be likely to join the Seventh Circuit in holding that *scienter* is not a necessary element to an action for damages brought under Rule 10b-5. In *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1968), *cert. denied*, 390 U.S. 951 (1968), plaintiffs brought actions against defendants under Rule 10b-5 for misrepresentation and non-disclosure of material facts relating to the sale of corporate stock. In affirming the judgment of the

* The Tenth Circuit, at substantial length, explains and distinguishes certain of its earlier decisions, *e.g.*, *Stevens* v. *Vowell*, 343 F.2d 374 (10th Cir. 1965), which other Courts erroneously construed as eliminating any *scienter* requirement.

District Court for plaintiffs, the Court of Appeals stated: "proof of '*scienter*', *i.e.*, knowledge of the falseness of the impressions produced by the statements or omissions made, is not required under Section 10(b) of the Act."* 386 F.2d 718, 734-735.

In *Vanderboom* v. *Sexton*, 422 F.2d 1233 (8th Cir. 1970), *cert. denied*, 400 U.S. 852 (1970), an action for "damages under Rule 10b-5 arising from allegedly untrue statements and misleading omissions made in connection with the sale of securities, the Eighth Circuit determined that the Arkansas statute of limitation for state securities act violations and not for common law fraud was applicable to the cause of action. The Arkansas securities act was found to bear a closer resemblance than common law fraud to a Rule 10b-5 action largely because negligence is not actionable as common law fraud while "the present rule in the Eighth Circuit is that Rule 10b-5 applies to negligent as well as intentional misrepresentations." 422 F.2d 1233, 1239. *See also* the companion case, *City National Bank* v. *Vanderboom*, 422 F.2d 221 (8th Cir. 1970).

In a recent Ninth Circuit decision, *White* v. *Abrams*, 495 F.2d 724 (9th Cir. 1974), the trial court had instructed the jury that a defendant could be held liable under Rule 10b-5 if he made a material misrepresentation to plaintiffs in connection with the sale of a security,

* This statement is *dictum* since the District Court required the jury to find "deceptive or manipulative conduct consisting of misrepresentations or omissions made with the *intent of* inducing plaintiffs to sell their stock." The Eighth Circuit notes that this charge "was more demanding than the broader express terms of the statute and the rule. . ." and that defendants were therefore not prejudiced. 386 F.2d 718, 735.

even if the defendant did not know of the falsity of the misrepresentation. The Ninth Circuit reversed, indicating that this formulation of absolute liability resulted from a misreading by the District Court of the Court of Appeals' opinions in *Ellis* v. *Carter,* 291 F.2d 270 (9th Cir. 1961), and *Royal Air Properties, Inc.* v. *Smith,* 312 F.2d 210 (9th Cir. 1961).* On remand the trial court was not instructed to apply a *scienter* test, but a newly formulated "flexible duty standard" which looks to "the extent of the duty that rule 10b-5 imposes on this particular defendant." The extent of duty will be determined by application of numerous factors some of which are listed by the court at 495 F.2d 724, 736:

> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

Although *White* v. *Abrams* adopts a novel approach, it appears certain that a cause of action based on mere negligence can be maintained under the new formulation. This rejection of the *scienter vel non* approach of the Second, Sixth and Tenth Circuits places the Ninth Circuit in direct conflict with these three circuits.

As is apparent from the discussion above, the Ninth Circuit and *dicta* in the Eighth Circuit are in accord

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* Language in these two cases, actually *dicta,* has been interpreted as recognizing a private cause of action under Rule 10b-5 for negligent misrepresentation absent any *scienter* requirement. *City National Bank* v. *Vanderboom, supra,* at 230.

with the Seventh Circuit's holding in the instant cases that a cause of action for damages brought under Rule 10b-5 may be sustained in the absence of any allegation of fraudulent or deceitful conduct or knowledge of such conduct on the part of the defendant, while the Second, Sixth and Tenth Circuits would hold that the same cause of action must be dismissed. This significant and substantial conflict justifies the issue of a writ of certiorari to review the judgment and opinion below.

Additionally, Petitioner requests that this Court take notice of the nationwide jurisdictional and broad venue provisions of Section 27 of the 1934 Act, 15 U.S.C. §78aa*, that many firms of certified public accountants, including Petitioner Ernst & Ernst, are multistate or national in character, and that unless this Court grants this petition and resolves the conflicting holdings of the Courts of Appeals, such accounting firms will face the prejudicial hardship that litigants desiring to bring suit on a cause of action under Rule 10b-5 grounded on negligence may elect to bring such action in a forum with favorable precedent.

Finally, Petitioner requests this Court to note that this issue is one of substantial consequence with respect to the permissible outreach of Rule 10b-5. The extension of Rule 10b-5 liability to negligent inaction imposes upon accounting firms, among others, the burden of broadly insuring the investing public against fraud in

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* "Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found."

which such parties have not participated and have no knowledge. The propriety of extending such liability to parties who have neither committed nor have any knowledge of wrongful conduct is an issue properly for this Court.

II. THE DECISION BELOW CONFLICTS WITH THE DECISIONS OF OTHER CIRCUITS AS TO WHETHER A STATUTE OF LIMITATIONS CAN BE TOLLED BY NEGLIGENT FACILITATION AND IMPLEMENTATION OF FRAUD.

Since Ernst & Ernst issued its last audit report in December 1967 and the first complaint in these cases was filed on February 19, 1971, the applicable three year statute of limitations* will bar this action unless the federal doctrine of fraudulent concealment has tolled the statute.**

The opinion of the Court of Appeals holds that although the charge against Ernst & Ernst "was grounded in negligence and not on any contention that the defendant was chargeable with acts of fraud or fraudulent concealment," Ernst & Ernst's "negligent facilitation and implementation of Nay's fraud can serve to toll the statute." (Appendix A, *infra*, pp. 33a-34a).

This holding is unique to this opinion and to the Court of Appeals' decision in the companion cases, *Hochfelder* v. *Midwest Stock Exchange, supra,** is in direct conflict with a recent holding of the Court of Appeals for the Fifth Circuit and is in conflict with principles expressed in cases decided in the Second and Tenth Circuits.**

In *Cato* v. *Southern Atlantic & Gulf Coast Dist. of Int'l Longshoremen's Ass'n,* 364 F. Supp. 489 (S.D. Tex. 1973) *aff'd., sub. nom. Cato* v. *Int'l Longshoreman's Ass'n.,* 485 F.2d 583 (5th Cir. 1973), an action was brought by certain union members against their district union and their employer. Plaintiffs alleged that the defendant-employer had terminated their employment without the notice and opportunity to bargain required by the Railway Labor Act, 45 U.S.C. §161, *et seq.* The District Court held that the plaintiffs' action against the defendant employer was barred by the applicable statute of limita-

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* In the absence of a provision in federal law (as is the case for actions brought under Sec. 10(b) and Rule 10b-5), the applicable statute of limitations is determined by reference to appropriate state law. *Int'l Union* v. *Hoosier Cardinal Corp.,* 383 U.S. 696, 704 (1966). Here, the Court of Appeals, in accord with its earlier decision in *Parrent* v. *Midwest Rug Mills, Inc.,* 455 F.2d 123 (7th Cir. 1972), properly applied the limitation of the Illinois Securities Law of 1953, Ill. Rev. Stat. ch. 121½, §137.1 *et seq.* (1973).

** Petitioner does not dispute the existence of the federal doctrine of fraudulent concealment, adopted by this Court in *Bailey* v. *Glover,* 88 U.S. (21 Wall) 342 (1875), nor that the doctrine is applicable to every federal statute of limitation. *Holmberg* v. *Armbrecht,* 327 U.S. 392, 397 (1945).

* Prior Seventh Circuit decisions have held that the doctrine of fraudulent concealment could toll the statute of limitations in actions brought under Sec. 10(b) and Rule 10b-5, but only under facts indicating that the defendant had actually concealed the fraud. *See, Morgan* v. *Koch,* 419 F.2d 993 (7th Cir. 1969); *Baker* v. *F & F Investment,* 420 F.2d 1191 (7th Cir. 1970).

** Additionally, this holding is in conflict with the opinions of the Second, Sixth and Tenth Circuits, discussed at pages 9-12 of this petition. Although none of these decisions is addressed to a statute of limitations question, for the Seventh Circuit to hold that a party without knowledge of or participation in fraud can *fraudulently* conceal a cause of action is not only a contradiction in terms but is also inconsistent with the holdings of these three Circuits.

tions and rejected the plaintiffs' argument that the statute was tolled by certain misrepresentations made by the defendant union representatives. No allegation was made that the defendant employer had made any fraudulent misrepresentations. The District Court held:

> Generally the acts of third parties in concealing a cause of action will not prevent the running of the limitations period as to the real defendant. The action by union officials can preserve plaintiffs' claim against the defendant district union, but it cannot save their claim against these defendants. 364 F. Supp. 489, 493.

The Fifth Circuit, affirming *per curiam*, specifically noted its agreement with the district court that the plaintiff's claim under the Railway Labor Act "is barred by the statute of limitations." 485 F.2d 583.

In *Detroit* v. *Grinnell Corp.*, 495 F.2d 448 (2d Cir. 1974), an antitrust action in which the plaintiffs claimed that the applicable statute of limitations was tolled by the federal doctrine of fraudulent concealment, the Second Circuit stated that one of the elements that a party relying on the doctrine of fraudulent concealment must show is "that *defendants* concealed the basic facts that would reveal the existence of their monopolistic behavior." 495 F.2d 448, 460. (Emphasis added) Similarly, in *Public Service Co.* v. *General Electric Co.*, 315 F.2d 306 (10th Cir. 1963), a cause of action for damages under the Clayton Act, the Sixth Circuit held that the applicable statute of limitations could be tolled if the cause of action was wrongfully and actively concealed, stating: "Wrongful active concealment concerns positive action *by the party against whom the right is asserted.*" 315 F.2d 306, 310, (Emphasis added).

As stated by this Court in *Burnett* v. *New York Central R.R. Co.*, 380 U.S. 424, 428 (1965):

> Statutes of limitations are primarily designed to assure fairness to defendants. Such statutes promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them.

The policy underlying statutes of limitations is to afford defendants such as accounting firms at least some protection against stale claims.* The holding adopted by the Seventh Circuit, besides being in sharp conflict with the holdings of other Courts of Appeals, is repugnant to this policy and particularly unjust to the accounting profession as an allegedly negligent auditor will effectively never be able to rely on a statute of limitations when an actively fraudulent party has deceived all concerned. Therefore, Petitioner requests that this Court grant a writ of certiorari to resolve this conflict of decisions and to correct the erroneous holding of the Court of Appeals.

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* In the instant case, some of the claims against Nay for which Ernst & Ernst is charged arose as many as 40 years prior to their discovery in 1968.

III. THE COURT BELOW HAS ERRONEOUSLY DECIDED AN IMPORTANT QUESTION OF LAW AS TO WHETHER PETITIONER IS ENTITLED TO A JUDGMENT AS A MATTER OF LAW (i) THAT RESPONDENTS FAILED TO EXERCISE DUE DILIGENCE IN OBTAINING KNOWLEDGE OF THE ALLEGED FRAUD AND THEREFORE CANNOT DEPEND ON THE DOCTRINE OF FRAUDULENT CONCEALMENT TO TOLL THE STATUTE OF LIMITATIONS AND (ii) THAT RESPONDENTS' KNOWLEDGE AND CONDUCT WAS SUCH TO CAUSE THEIR CLAIMS TO BE BARRED BY THE DOCTRINE OF EQUITABLE ESTOPPEL.

As noted in the opinion of the Court of Appeals, Ernst & Ernst regularly mailed confirmation slips to Respondents with respect to their open accounts. None of Respondents at any time informed Ernst & Ernst that the alleged escrow transactions were part of their accounts at First Securities, but instead confirmed their accounts as correct. (Appendix A, *infra*, p. 27a). Moreover, the record in these cases, totally uncontroverted by Respondents, shows that the checks the Respondents received with regard to their escrow accounts were drawn by Nay and not by First Securities and that they did not receive monthly statements with respect to their escrow accounts.

The opinion of the Court of Appeals properly notes that the doctrine of fraudulent concealment tolls the statute of limitations "until the plaintiff has obtained knowledge of the fraud or in the exercise of due care should have obtained knowledge of the fraud." (Appendix A, *infra*, p. 33a). However, the Court of Appeals holds:

> Whether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be decided at a trial. (Appendix A, *infra*, p. 34a).

Similarly, the Court of Appeals states that estoppel is a proper affirmative defense to a claim of aiding and abetting a Rule 10b-5 violation and that if Respondents knew or should have known they were to report their escrow accounts on the confirmation forms and failed to do so, they are estopped from complaining of Ernst & Ernst's failure to uncover or prevent the fraud. However, the Court of Appeals holds:

> Whether plaintiffs knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on the confirmation requests is a question to be decided by the fact finder. (Appendix A, *infra*, pp. 31a-32a).

The only conclusion that this Court can draw from the uncontroverted evidence is that Respondents did not exercise due diligence in obtaining knowledge of Nay's alleged fraud, that they knew or should have known that they were required to report the escrow accounts on the confirmation forms, that Respondents therefore cannot depend on the doctrine of fraudulent concealment to toll the statute of limitations* and that additionally Respondents are barred by the doctrine of estoppel from prosecuting their claims.

The importance of this question arises from the context of these cases. The Court of Appeals causes grave conse-

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* Moreover, the Seventh Circuit's recent decision in *Hupp* v. *Gray*, 500 F.2d 993 (7th Cir. 1974), decided subsequent to the instant cases, clearly places the burden *on the plaintiff*, when relying on the doctrine of fraudulent concealment, to show reasonable care and diligence in attempting to learn of the fraud. Absolutely nothing in the record in these cases indicates that Respondents have met this burden. *Accord, Detroit* v. *Grinnell Corp., supra*, at 461.

quences to the accounting profession by holding that auditors cannot rely on confirmation procedures which, as the opinion of the Court of Appeals specifically notes (Appendix A, *infra*, p. 26a), are required by the rules of the Securities and Exchange Commission. For this reason, and for the additional reason that Ernst & Ernst has clearly met the burden of Rule 56(c) of the Federal Rules of Civil Procedure,* Petitioner requests this Court to issue a writ of certiorari to review the decision of the Court of Appeals.

IV. THE DECISION BELOW ERRONEOUSLY DECIDES AN IMPORTANT QUESTION AS TO WHETHER PETITIONER IS ENTITLED TO A JUDGMENT AS A MATTER OF LAW THAT PETITIONER EXERCISED ALL DUE CARE AND DILIGENCE IN ACCORDANCE WITH GENERALLY ACCEPTED AUDITING STANDARDS IN CONDUCTING ITS AUDITS OF FIRST SECURITIES.

The opinion of the Court of Appeals holds that there are genuine issues of material fact to be decided at trial regarding whether Nay's mail rule was a material inadequacy in First Securities' system of internal accounting control and whether Ernst & Ernst failed to exercise the due care required of a professional auditor in accordance with generally accepted auditing standards in that it did not discover a material inadequacy in First Securities' internal accounting control. (Appendix, A, *infra*, p. 18a).

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* Ernst & Ernst, as the moving party, must be granted summary judgment if the record shows "that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."

This holding is in clear contradiction to the record established in this case and to the findings of the District Court and, if permitted to remain uncorrected, will cast great doubt on the efficacy of the summary judgment procedure in the Seventh Circuit. Ernst & Ernst appended to its motion for summary judgment the affidavits of two experts in accounting for broker-dealers who on personal knowledge stated that Ernst & Ernst's audits met generally accepted auditing standards. Respondents submitted the affidavits of a national bank examiner, who not being a certified public accountant was not qualified to comment on whether Ernst & Ernst's audits of First Securities were conducted in accordance with generally accepted auditing standards, and the affidavits of two retired certified public accountants, neither of whom had any personal familiarity with First Securities or Ernst & Ernst or expressed anything more than his personal opinion with respect to what he might have done had he audited the accounts of a broker-dealer and had he discovered a "mail rule'" such as Nay's.

As the affidavits submitted by Ernst & Ernst attesting that Ernst & Ernst fully complied with generally accepted auditing standards are totally uncontroverted by any competent evidence submitted by Respondents, Ernst & Ernst submits it has met the burden required by Rule 56(c) of the Federal Rules of Civil Procedure and that for this reason a writ of certiorari should issue to review and to correct the decision to the Court of Appeals.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Nos. 73-1907 and 73-1908
OLGA HOCHFELDER, et al.,
Plaintiffs-Appellants,
v.
ERNST & ERNST,
Defendant-Appellee.
LEON S. MARTIN, et al.,
Defendants-Appellants,
v.
ERNST & ERNST,
Defendant-Appellee.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

Nos. 71 C 454
71 C 1204

THOMAS R. McMILLEN, *Judge.*

ARGUED APRIL 19, 1974—DECIDED AUGUST 30, 1974

Before SWYGERT, *Chief Judge,* CASTLE, *Senior Circuit Judge,* and SPRECHER, *Circuit Judge.*

SWYGERT, *Chief Judge.* Plaintiffs appeal from a grant of summary judgment in favor of the defendant Ernst & Ernst, a firm of independent certified public accountants. The plaintiffs were investors[1] in a fraudulent securities

[1] The plaintiffs in Appeal No. 73-1907, Olga Hochfelder, et al., filed an action on February 19, 1971 in district court against the Midwest Stock Exchange and Ernst & Ernst. On May 18, 1971 a separate but identical complaint was filed by plaintiffs Leon S. Martin, et al., in Appeal No. 73-1908. Midwest and Ernst & Ernst filed motions for summary judgment applicable to both cases. The district court granted summary judgment in favor of the Midwest

scheme perpetuated by Leston B. Nay, President of First Securities Company of Chicago and owner of ninety-two percent of its stock. First Securities was a small brokerage firm in Chicago which was registered with the Securities and Exchange Commission as a brokerage dealer in securities and was a member of the Midwest Stock Exchange as well as the National Association of Securities Dealers, Inc. First Securities retained Ernst & Ernst as auditors beginning in 1946 and continued to engage its services up through the last audit of First Securities performed in November, 1967.

The instant action emanates from Leston B. Nay's fraudulent securities scheme which we have described in detail in our opinion in *Securities & Exchange Com'n* v. *First Securities Co. of Chicago,* 463 F. 2d 981 (7th Cir. 1972), and which needs only be briefly recounted here. The plaintiffs were brokerage clients of First Securities, dealing in securities through First Securities in regular fashion. Each plaintiff received investment counselling from Nay, and each knew Nay to be the president of First Securities. Nay induced the plaintiffs to invest funds in an "escrow" account which Nay represented would yield interest to plaintiffs at a high rate of return. Plaintiffs began to invest in the escrow accounts as early as 1942 with the majority of the transactions entered into in the 1950's and the last of the escrow transactions consummated in 1966. It was not until 1963 that Nay's fraudulent scheme was discovered as a result of a suicide

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[1] (Continued)

Stock Exchange which we affirmed in the consolidated appeal. *Hochfelder, et al. and Leon S. Martin, et al.* v. *Midwest Stock Exchange,* Nos. 72-1977, 72-1978 (April 10, 1974). Subsequent to the grant of summary judgment to Midwest, the district court granted summary judgment in favor of Ernst & Ernst. The appeals were consolidated by stipulation of the parties and our order of November 13, 1973.

note left by Nay describing First Securities as bankrupt due to his thefts and indicating that certain escrow accounts created by him were "spurious." Plaintiffs had invested in the "spurious" escrow accounts. As a result of his actions, we held in *Securities & Exchange Com'n.* v. *First Securities Co. of Chicago,* 463 F. 2d 981, 986 (7th Cir. 1972), that "Nay's conduct violated the provisions of section 10(b) of the Securities Exchange Act of 1934 and its regulatory corollary, Rule 10b-5," and that First Securities was chargeable with Nay's fraud as an aider and abettor to Nay's Rule 10b-5 violation.

In the instant action the plaintiffs claim that Ernst & Ernst was negligent in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation. It is contended that had Ernst & Ernst duly executed its audit of First Securities Nay's fraudulent scheme would have been uncovered or prevented.

In resolving this appeal we must address the following matters: (1) the elements of a *prima facie* case for aiding and abetting must be properly defined; (2) the propriety of the district court's ruling that the evidence presented no genuine issue of material fact as to the adequacy of Ernst & Ernst's audits of First Securities under applicable auditing standards; (3) whether the district court correctly ruled that plaintiffs' claims against Ernst & Ernst are estopped by their conduct prior to the presentment of such claims; and (4) whether the district court properly held that plaintiffs' claims against Ernst & Ernst are barred by the applicable statute of limitations.

In granting summary judgment for Ernst & Ernst the district judge found that there were no genuine issues of material fact and held that on the basis of the uncontroverted evidence Ernst & Ernst was entitled to judgment as a matter of law. But it is our view there are genuine issues of material fact in dispute which go to the very question of liability. We hold, therefore, that this was not an appropriate case for summary judgment and accordingly reverse and remand for trial.

I

Ernst & Ernst contends that as a matter of law, it cannot be held liable for aiding and abetting Nay's fraud in view of the fact that admittedly it had no knowledge of Nay's fraudulent escrow scheme. We have indirectly passed upon this contention in our recent decision in *Hochfelder, et al. and Martin, et al.* v. *Midwest Stock Exchange,* Nos. 72-1977, 72-1978 (April 10, 1974) where we stated that a claim for aiding and abetting solely by inaction can be maintained under Rule 10b-5 by a showing:

> "that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure."

The foregoing elements comprise a flexible standard of liability which should be amplified according to the peculiarities of each case. Accordingly, where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating; (1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention. As our analysis will demonstrate, plaintiffs state a claim of aiding and abetting a Rule 10b-5 violation under the foregoing elements.

II

With respect to the existence of a duty of inquiry it is clear that Ernst & Ernst's contractual arrangement

whereby it undertook to audit First Securities gave rise to a common law duty of inquiry. The extent and scope of that duty will be the subject of additional analysis; for present purposes, however, it is sufficient to state that Ernst & Ernst's audit engagement imposed a common law duty of inquiry.

In addition, having undertaken the contractual duty to audit First Securities and prepare SEC Form X-17A-5 pursuant to section 17(a) of the Securities Exchange Act and SEC Rule 17a-5 thereunder,[2] a statutory duty of inquiry is properly imposed on Ernst & Ernst. Section 17(a) and its corollary Rule 17a-5 require a member of a national securities exchange to file with the SEC an annual report of financial condition certified by an independent certified public accountant, which report meets the requirements of Form X-17A-5. In accordance with the provisions of section 17(a) and Rule 17a-5 First Se-

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[2] Section 17(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78q(a), provides:

> "(a) Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 780 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors. Such accounts, correspondence, memoranda, papers, books, and other records shall be subject at any time or from time to time to such reasonable periodic, special, or other examination by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors.

Pursuant to this statutory section, the Securities and Exchange Commission promulgated Rule 17a-5, 17 C.F.R. §240.17a-5.

curities retained Ernst & Ernst. Thus, we find Ernst & Ernst chargeable additionally with a statutory duty of inquiry.

III

The plaintiffs must establish that they were beneficiaries of Ernst & Ernst's duty of inquiry. Unlike the common law duty of inquiry whose benefaction is narrowly drawn, it would appear that the statutory duty of inquiry imposed on the defendant inured to the benefit of plaintiffs.

Section 17(a) requires the maintenance by brokers and dealers of reports and records pertaining to their financial affairs and the submission of these reports and records to the Securities and Exchange Commission. The Commission is specifically directed to prescribe those reports and records "necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. §78q(a). The explicit thrust of this statutory section is the dominant concern evinced by the whole of the securities acts that those comprising the investing public be adequately safeguarded in their financial dealings with security brokers. Without reaching the question of whether there is implicit in section 17(a) a direct duty flowing to the plaintiffs, it is enough for purposes of proving defendant's aid and abetment of a Rule 10b-5 violation that the extant duty of inquiry imposed on Ernst & Ernst is grounded on a concern for the protection of investors such as the plaintiffs.

At common law the duty of inquiry owed by Ernst & Ernst would not extend to the plaintiffs. The defendant's common law duty emanates from its contract to audit First Securities. Plaintiffs were not a party to that contract or an intended third-party beneficiary. There is therefore an absence of privity between the parties, precluding action by the plaintiffs on the contract for a breach of duty. Arising out of the contractual arrangement, however, is a corollary duty of inquiry fashioned

by decisional law and sounding in tort. The first significant case extending liability for negligence beyond privity of contract where, as here, only intangible economic damages were involved, was *Glanzer* v. *Shepard*, 233 NY. 236, 135 N.E. 275 (1922).[3] In that case, the court rejected the argument that no duty was owed to the plaintiffs because there was no contract between them and defendant. Plaintiffs were purchasers of a quantity of beans. The seller contracted with the defendant, a public weigher, to certify the correct weight of the beans. The defendant knew that the plaintiffs were to use the certificates as the basis for their payment to the seller. The defendant negligently overstated the weight, and as a result the plaintiffs overpaid. In allowing the plaintiffs to recover for their economic damages, Judge Cardozo, holding that there was a duty owed to the plaintiffs, wrote:

> "We do not need to state the duty in terms of contract or of privity. Growing out of a contract, it has nonetheless an origin not exclusively contractual. Given the contract and the relation, the duty is imposed by law." 233 N.Y. at 239; 135 N.E. at 276.

Although the opportunity to state the duty in terms of contract was available.[4] Cardozo chose to fashion the duty in tort, observing that "the bounds of duty are enlarged by knowledge of a prospective use." 233 N.Y.

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[3] In the realm of tangible, physical harm and damage to persons and property arising out of the negligent performance of a contract, the defense of privity of contract was effectively abrogated six years prior to the decision in *Glanzer* by Judge Cardozo's opinion in *MacPherson* v. *Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916).

[4] Cardozo recognized that the duty could have been stated in contract. 233 N.Y. at 241; 135 N.E. at 277. In view of the specific nature of the transaction and the relationship of the parties, the third-party beneficiary rule of *Lawrence* v. *Fox*, 20 N.Y. 268 (1859), would have been apposite.

at 240, 135 N.E. at 276. *Glanzer* was viewed as the precursor of a general duty of reasonable care to avoid all foreseeable risks of economic damages to third persons not in privity of contract.[5]

Nine years after the decision in *Glanzer,* Cardozo rendered his opinion in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441 (1931). There he refused to extend the scope of liability for economic damages caused by negligence to the full limits of foreseeability in favor of a third party not in privity. In *Ultramares* the defendants, a firm of certified public accountants, were negligent in their audit of a company, Fred Stern & Co., to which the plaintiff had loaned money in reliance on the accountants' audit. The accountants did not know the exact persons to whom the certified balance sheet would be shown nor did they know that the financial statements would be submitted to the plaintiff. It was foreseeable however that Stern and Company in the ordinary course of its business would exhibit the financial statements to creditors and investors. Accordingly, it was generally foreseeable that the plaintiff would rely on the statements. Cardozo, in questioning the wisdom of a duty owed to all who might foreseeably rely on financial statements which were negligently audited, observed:

> "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." 255 N.Y. at 179; 174 N.E. at 444.

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[5] See, *e.g.,* Note, *Privity of Contract and Tort Liability,* 21 Mich. L. Rev. 200 (1922).

Declining to extend his decision in *Glanzer* v. *Shepard,* Cardozo instead distinguished *Glanzer,* stating:

> "In *Glanzer* v. *Shepard,* the seller of beans requested the defendants, public weighers, to make return of the weight and furnish the buyer with a copy. . . . Here was something more than the rendition of a service in the expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here was a case where the transmission of the certificate to another was not merely one possibility among many, but the 'end and aim of the transaction,' . . . In a word, the service rendered by the defendant in Glanzer v. Shephard was primarily for the information of a third person, in effect, if not in name, a party to the contract, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the benefit of the Stern Company . . . and only incidentally or collaterally for use of those to whom Stern and his associates might exhibit it thereafter." 255 N.Y. at 182; 174 N.E. at 445-46.

Ultramares set the outer limit of an accountant's common law liability for it established that there was no duty owing to all who might foreseeably rely on an accountant's negligent misrepresentation. There existed the possibility, by analogy to *Glanzer* v. *Shepard,* that an accountant owed a duty to those third persons whose potential reliance on the financial statements was specifically known to the accountant, the so-called "foreseen plaintiff." The courts, however, have declined to accept the *Glanzer* analogy, viewing *Ultramares* as holding that accountants owe no duty to persons not in privity of contract. *See, e.g., O'Connor* v. *Ludlam,* 92 F.2d 50 (2d Cir. 1937); *State Street Trust Co.* v. *Ernst,* 278 N.Y. 104, 15 N.E. 2d 416 (1938); *Duro Sportswear, Inc.* v. *Cogen,* 131 N.Y.S. 2d 20 (Supr. Ct. 1954), *aff'd without opinion,* 285 App. Div. 864, 137 N.Y.S. 2d 829 (1955);

C.I.T. Financial Corp. v. *Glover*, 224 F.2d 44 (2d Cir. 1955); *Candler* v. *Crane, Christmas & Co.*, [1951] 2 K.B. 164; *Investment Corporation of Florida* v. *Buchman*, 208 So. 2d 291 (Fla. Ct. App. 1968). It is only in recent years that inroads have been made on the reach of the *Ultramares* decision. *See, e.g., R.I. Hospital Trust Nat'l Bank* v. *Swartz, et al.*, 455 F.2d 847, 851 (4th Cir. 1972); *Rusch Factors, Inc.* v. *Levin*, 284 F.Supp. 85 (D.R.I. 1968); *Ryan* v. *Kanne*, 170 N.W. 2d 395 (Iowa 1969); *Shatterproof Glass Corp.* v. *James*, 466 S.W. 2d 873 (Tex. Civ. App. 1971). The courts in diminishing the impact of *Ultramares* have not only embraced the rule of *Glanzer* —liability to a foreseen plaintiff—but have extended an accountant's liability for negligence to those who, although not themselves foreseen, are members of a limited class whose reliance on the financial statements is specifically foreseen.

We agree with the defendant that there is no common law duty of inquiry owed the plaintiffs in the case at bar. Plaintiffs ground the instant action on the basis of their membership in a class of escrow claimants. It is clear that at no time did Ernst & Ernst specifically foresee that plaintiffs' limited class might suffer from the consequences of a negligent audit on its part. More important, however, is the plaintiffs' admitted lack of reliance on the financial statements and reports prepared by Ernst & Ernst and Ernst & Ernst's certificate of opinion. The common law action against a public accountant independent of an action on the contract is grounded on negligent misrepresentation; this necessarily requires direct reliance of some sort by the plaintiff on the professional services rendered by the accountant. Absent such reliance no common law duty is involved. Accordingly, we must continue our analysis only with respect to Ernst & Ernst's statutory duty of inquiry.

IV

In determining whether Ernst & Ernst breached its statutory duty of inquiry our examination is twofold:

(1) the scope of Ernst & Ernst's duty of inquiry must be ascertained; and (2) the standard of conduct by which Ernst & Ernst executed its duty must be delineated.

Going first to the last element, we are of the view that when accountants undertake to perform an audit, they are required to meet only the standard of care reasonably expected of persons holding themselves out as skilled accountants. We agree with Judge McLean that, in general, "accountants should not be held to a standard higher than that recognized in their profession." *Escott* v. *Barchris Construction Corp.*, 283 F.Supp. 643, 703 (S.D. N.Y. 1968). Accordingly, the standard of care which generally prevailed in the accounting profession during the years of Ernst & Ernst's audits of First Securities is the standard to which Ernst & Ernst must be held.

The extent or scope of Ernst & Ernst's statutory duty of inquiry imposed by section 17(a) and Rule 17a-5 is clearly set forth in Form X-17A-5:

> "The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date."

This duty to audit in accordance with generally accepted auditing standards does not differ from the duty which is otherwise imposed by law. *Wessel* v. *Buhler*, 437 F.2d 279, 283 (9th Cir. 1971); *Caddell* v. *Goodbody & Co.*, CCH Fed. Sec. L. Rep ¶93,938, p. 93,740 (N.D. Ala. 1972); or the

accounting profession itself. American Institute of Certified Public Accountants, *Audits of Brokers and Dealers in Securities* (1956).

Moreover, with regard to accountants' duty to uncover fraud or irregularities, we think that in general it is properly stated that:

> "In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate mispresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards."[6]

With this statement in mind, the statutory duty of inquiry was breached if it can be shown that Ernst & Ernst in failing to attain the professional standard of care did not conduct its audit of First Securities in accordance with the requirements set forth therein.

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[6] *Auditing Standards and Procedures.* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at pp. 10-11 (1963).

V

We come then to the fundamental issue in this lawsuit: Whether the uncontroverted evidence reveals that Ernst & Ernst conducted its audits with all due care and in accordance with generally accepted auditing standards. Plaintiffs contend that Ernst & Ernst negligently failed to detect and report an alleged lack of adequate internal accounting controls of First Securities which resulted from Nay's "mail rule" and that Ernst & Ernst thereby failed to meet generally accepted auditing standards. Nay's "mail rule" was an office rule which he imposed on all employees of First Securities whereby he directed that all mail addressed to him or to the company for his attention was to be opened by no one other than him and that when he was away from the office the mail was to be placed on his desk unopened regardless of the duration of his absence from the office. Plaintiffs say that Nay's "mail rule" was the key to the concealment of his fraudulent escrow scheme and that the defendant's regulatory duty extended to investigate this practice. On the other hand, Ernst & Ernst argues that even taking into account these mail procedures its audits were conducted in accordance with generally accepted auditing standards and that First Securities maintained adequate internal accounting controls.

It is clear that as part of Ernst & Ernst's duty to conduct its audit in accordance with generally accepted auditing standards it was incumbent on it to investigate Frst Securities' system of internal accounting controls. The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants provide in pertinent part:

> ". . . .
> *Standards of Field Work*
> . . . .
> 2. There is to be a proper study and evaluation of the existing internal control as a basis for reli-

ance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.'"[7]

Moreover, SEC From X-17A-5, in directing that the accountant's audit be conducted in accordance with general accepted auditing standards, emphasizes that those standards shall include a review of the internal accounting control.[8] There is therefore no question but that Ernst & Ernst was under a duty to investigate the internal accounting controls of First Securities.

Ernst & Ernst says that there may be misapprehension about the function of internal accounting control. It contends that the function of internal accounting control is not to insure the detection of all irregularities, but rather to determine the extent to which an auditor can rely on the accounting records of the firm to produce a fair reflection of its financial condition and to provide reasonable assurance as to the safeguarding of assets against loss from unauthorized use or disposition.

[7] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 16 (1963).

[8] The audit requirements of SEC Form X-17A-5 provide in relevant part:

"The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, *the internal accounting control* and procedures for safe-guarding securities including appropriate tests thereof for the period since the prior examination date. It shall include all procedures necessary under the circumstances to substantiate the assets and liabilities and securities and commodities positions as of the date of the responses to the financial questionnaire and to permit the expression of an opinion by the independent public accountant as to the financial condition of the respondent at that date." [Emphasis added].

Internal accounting controls, as defined by the American Institute of Certified Public Accountants (American Institute), comprise:

"The plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing."[9]

Moreover, as noted by the American Institute: "A function of internal control, from the viewpoint of the independent auditor, is to provide assurance that errors and irregularities may be discovered with reasonable promptness, thus assuring the reliability and integrity of the financial records."[10] With respect to the prevention and detection of fraud the American Institute observes:

"6. Reliance for the prevention and detection of fraud should be placed principally upon an adequate accounting system with appropriate internal control. The well-established practice of the independent auditor of evaluating the adequacy and effectiveness of the system of internal control by testing the accounting records and related data and by relying on such evaluation for the selection and timing of his other auditing procedures has generally proved sufficient for making an adequate examination. If an objective of an independent auditor's examination

[9] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 28 (1963).

[10] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 32 (1963).

> were the discovery of all fraud, he would have to extend his work to a point where its cost would be prohibitive. Even then he could not give assurance that all types of fraud had been detected, or that none existed, because items such as unrecorded transactions, forgeries, and collusive fraud would not necessarily be uncovered. Accordingly, it is generally recognized that good internal control and fidelity bonds provide protection more economically and effectively."[11]

It is Ernst & Ernst's view that in light of the aforementioned purpose and function of internal accounting controls, Nay's mail rule was not relevant to the system of internal accounting control and that in any event First Securities maintained adequate internal accounting controls.

Plaintiffs meet Ernst & Ernst's contention with the affidavits of three former auditors. Fred J. Duncombe, past President of the Illinois Society of Certified Public Accountants and former Chairman of the Committee on Accountancy of the University of Illinois, stated in his affidavit: "If I had discovered in making an audit of a brokerage company that the President of the Company had established an office rule that all mail addressed to him or to the Company for his attention should not be opened by anyone but him; and that when he was away from the office for a few days, the mail addressed to him or to the Company for his attention piled up on his desk, I would not have regarded that brokerage firm as having adequate internal accounting control and would not have certified that a report based on such an audit fairly represented the financial position of the Company." To the same effect affiant Michael K. Garst, a national bank examiner of 25 years experience, indicated that under the circumstances he would have regarded Nay's "mail rule" as a

[11] *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33, American Institute of Certified Public Accountants at p. 11 (1963).

possible violation of duality of control and would have appropriately commented on it. Likewise Gerhard Mayer, a certified public accountant with thirty years experience, comments in his affidavit: "If I had discovered in making an audit of a security brokerage business that its president had established an office rule that mail addressed to him at the business address, or to the company for his attention should not be opened by anyone but him, even in his absence; and that whenever he was away from the office such mail would remain unopened and pile up on his desk I would have to raise the question whether such rule or practice could possibly have been instituted for the purpose of preventing discovery of irregularities of whatever nature; would, as a minimum, have to undertake additional audit procedures to independently establish a negative answer to the latter question; also failing such an answer either withdraw from the engagement or decline to express an opinion on the financial statements of the enterprise."

The foregoing statements go directly to the adequacy of First Securities' system of internal accounting controls and the sufficiency of Ernst & Ernst's review of those controls. In essence they challenge Ernst & Ernst's contention that all audits of First Securities were performed in accordance with generally accepted auditing standards. That is, a negligent failure to discover a material inadequacy in internal accounting controls does not satisfy the generally accepted auditing standard that there "be a proper study and evaluation of the existing internal control." *Auditing Standards and Procedures,* Statement on Auditing Procedure No. 33, American Institute of Certified Public Accountants, at p. 16 (1963).

We realize that there never can be attainment of a perfect or a fail-safe system of internal accounting controls. The most sophisticated system of internal control may harbor inadequacies of some nature. Accordingly, the inadequacy in internal control is of signal importance

only when it enters the realm of materiality.[12] To that end we agree with the American Institute of Certified Public Accountants that:

> "A material inadequacy [in internal accounting control] can be defined as a condition that would permit a person acting individually in the brokerage concern's organization to perpetrate errors or irregularities involving the accounting records, assets of the brokerage concern, and/or assets of customers that would not be detected through the internal control procedures in time to prevent material loss or misstatement of the concern's financial statements, or serious violation of rules of the regulatory agencies."[13]

On the basis of the foregoing, therefore, there are genuine issues of material fact to be properly decided by a trial: (1) whether Nay's "mail rule" constituted a material inadequacy in First Securities' system of internal accounting control; and (2) whether Ernst & Ernst failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control.[14] An affirmative finding on both issues

[12] Indeed, it is presently an express audit requirement of SEC Form X-17A-5 that the accountant comment on any *material* inadequacy in internal accounting control. The relevant portion of the audit requirements provide that:

> "Based upon such audit, the accountant shall comment upon any material inadequacies found to exist in the accounting system, the internal accounting control and procedures for safeguarding securities, and shall indicate any corrective action taken or proposed. These comments may be submitted in a supplementary certificate and filed pursuant to Rule 17a-5(b)(3)."

[13] Audits of Brokers and Dealers in Securities, American Institute of Certified Public Accountants, at p. 71 (1963).

[14] To the extent that plaintiffs' charge regarding First Securities' vacation policy is relevant to a determination of the adequacy of internal accounting controls, they may offer evidence with respect thereto.

will therefore satisfy the third element of Plaintiffs' claim of aiding and abetting, namely, a showing of a breach of duty of inquiry.

VI

Plaintiffs further contend that Ernst & Ernst was under a duty of inquiry to detect and report First Securities' noncompliance with Rule 27(c) of Article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (N.A.S.D.)[15] In *Securities & Exch. Com'n* v. *First Securities Co. of Chicago*, 463 F. 2d 981 (7th Cir. 1972), we held that First Securities' enforcement of Nay's "mail rule" was sufficient without more to constitute a violation of Rule 27. Accordingly, we found First Securities, a member of the N.A.S.D., liable for Nay's fraud, due to its failure to enforce Rule 27. In *Hochfelder, et al.* v. *Midwest Stock Exchange*, Nos. 72-1977, 72-1978 (April 10, 1974) plaintiffs raised a contention, somewhat similar to the one they raise here, that the Midwest Stock Exchange was under a duty to enforce the rules of the N.A.S.D. In response to that contention we observed (at pp. 13-14):

[15] Rule 27 in pertinent part provides:

> "(a) Each member [of the Association] shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.
>
> "(b) Final responsibility for proper supervision shall rest with the member. . . .
>
> "(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction."

"In this action plaintiffs request that we place a duty on Midwest as a national securities exchange to enforce the rules of another self-regulatory organization, namely, the N.A.S.D., a national securities' association. Without facing the question whether even the N.A.S.D. as promulgator of Rule 27 could be liable because of its member's noncompliance, plaintiffs would have us place an additional burden on Mid-West to enforce the rules of another self-regulatory body. There is nothing in the 1934 Act which mandates the unique theory. Indeed, the imposition of such a burden of enforcement would be unduly onerous and result in a wasteful duplication of actions in that Midwest would be expected to enforce the rules of all self-regulatory organizations to which a member firm might belong. This would be contrary to the avowed intention of Congress and the Securities and Exchange Commission that there be more co-ordination and less duplication of self-regulatory activities. We hold that Midwest was under no duty to enforce Rule 27(c) of the Rules of Fair Practice of the N.A.S.D."

In the instant action the posture of plaintiffs' contention that Ernst & Ernst was under a duty to examine First Securities' compliance with the Rules of Fair Practice of the N.A.S.D. and in particular Rule 27(c) is: Public accountants are chargeable with a general duty of examining N.A.S.D. member firms for compliance with N.A.S.D. rules in view of the fact that the self-regulatory organization which promulgated the rules, the N.A.S.D., has failed to conduct examinations verifying compliance with its rules. Moreover, plaintiffs in effect claim that the duty to investigate compliance with the N.A.S.D. Rules of Fair Practice is necessarily encompassed within the body of generally accepted auditing standards. Ernst & Ernst makes the counter argument that neither SEC Rule 17a-5, Form X-17A-5, nor generally accepted auditing standards require that an auditor of a securities broker or dealer who is also a member of N.A.S.D., has any duty

to review compliance by the broker or dealer with the rules of the N.A.S.D. It is claimed that such an examination for compliance with N.A.S.D. rules is entirely outside of the scope of an audit.

A fair reading of SEC Rule 17a-5 and Form X-17-A-5 indicates that no duty is imposed on an auditor to ascertain compliance with N.A.S.D. rules. Moreover, it appears that the perceptible body of generally accepted auditing standards does not embrace such a requirement of audit review. In addition, even if plaintiffs were to be heard to complain of a contractual breach of duty by Ernst & Ernst, it is clear that Ernst & Ernst was not retained to verify First Securities' compliance with the N.A.S.D. Rules of Fair Practice.

Although plaintiffs' proposition is somewhat novel, we recognize, in agreement with the accounting profession, that it is not entirely devoid of merit. In the American Institute of Certified Public Accountants' industry audit guide on *Audits of Brokers and Dealers in Securities* the admonition is given (at p. 3):

> "In addition to a familiarity with the above rules of the Securities and Exchange Commission, it is necessary for the independent public accountant to have a working knowledge of Regulations T and U of the Board of Governors of the Federal Reserve System, and, if his client is a member of a stock exchange or the National Association of Securities Dealers, Inc., he should be familiar with the pertinent rules of those organizations. It is also considered advisable to review the applicable Accounting Series and other releases which are published from time to time by the Securities and Exchange Commission."

And, although the defendant correctly states that generally accepted auditing standards do not ordinarily require such investigation, we do not find that entirely compelling. The teaching of *The T. J. Hooper*, 60 F. 2d 737 (2d Cir. 1932), is not lost to us for we recognize that we are not

constrained to accept faulty standards of practice otherwise generally accepted in an industry or profession.[16] Moreover, the potential for imposition of liability on a broker or dealer for noncompliance with N.A.S.D. rules would seem to undermine the auditor's ability to represent that the financial statements fairly reflect the financial position[17] of the broker or dealer unless some sort of inquiry were made into compliance with those rules.

To countenance the duty of inquiry advocated by plaintiffs, however, would in our judgment be inappropriate. To direct full examination for compliance with the various rules of all the self-regulatory organizations to which a broker or dealer might belong would be to impose a burden of inquiry—otherwise not demanded by contract, statutory law, or professional practices—of indefinable proportions which arguably could never effectively and

[16] Judge Learned Hand aptly stated in *the T. J. Hooper* decision:

> "There are, no doubt, cases where courts seem to make the general practice of the calling the standard of proper diligence; we have indeed given some currency to the notion ourselves. Ketterer v. Armour & Co. (C. C. A.) 247 F. 921, 931, L.R.A. 1918D, 798; Spang Chalfant & Co. v. Dimon, etc., Corp. (C. C. A.) 57 F.(2d) 965, 967. Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission. 60 F.2d at 740.

[17] Ernst & Ernst utilized a short-form auditor's report or certificate typical in style to that customarily used (and suggested by the SEC) in which Ernst & Ernst represented in an opinion paragraph that the material in the financial questionnaire filed with the Securities and Exchange Commission presented fairly the financial position of First Securities.

completely be implemented. We cannot subscribe to a situation whereby the accountant has the burden of an investigation which is unascertainable and everchanging.

In summary, the burden of inquiry as to compliance with N.A.S.D. rules is placed with the N.A.S.D., where it should properly repose, for it is the promulgator of those rules and as such should command adherence thereto. Ernst & Ernst, as auditor of a member firm of the N.A.S.D., need have only inquired as to whether the member firm received an adverse report following an examination by the N.A.S.D. Having carried the inquiry that far, Ernst & Ernst cannot be charged with more.

VII

If it were found after a trial that Ernst & Ernst breached its statutory duty of inquiry by failing to exercise due care in coming to the knowledge of a material inadequacy in the internal accounting controls of First Securities, it would follow that Ernst & Ernst concomitantly breached an extant duty of disclosure. As we have previously stated, a breach of Ernst & Ernst's statutory duty of inquiry is a failure on its part to adhere with generally accepted auditing standards and as such clearly would not comport with the representation it made in its audit certificates that the audits were performed in accordance with generally accepted auditing standards.[18] To prevent such a misrepresentation and to comply with the disclosure requirement of Rule 17a-5(g)(2)(B),[19] it would, at a minimum,

[18] In its certificate Ernst & Ernst invoked the customarily used scope paragraph whereby the representation was made that Ernst & Ernst conducted its examination of First Securities "in accordance with generally accepted auditing standards." In addition, Ernst & Ernst expressly represented that their examination "included a review of the system of internal control."

[19] Rule 17a-5(g)(2)(B) provided:

> "(g) *Accountant's Certificate.*
>
> . . . .

be incumbent on Ernst & Ernst to disclose its departure from generally accepted auditing standards which of course it did not do.

More specifically, the duty, as part of generally accepted auditing standards to investigate internal accounting controls, necessarily implies that any material inadequacy in those controls will be disclosed.[20] Indeed, it is our view that a material inadequacy in internal accounting controls is a matter to which the accountant must properly take exception and to that end we note the requirements of Rule 17a-5(i) which direct that: "Any matters to which the accountant takes exception shall be clearly identified;

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[19] (Continued)

(2) Representations as to Audit. The accountant's certificate . . .
(B) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances. . . ."

[20] As the American Institute of Certified Public Accountants presently notes in its industry audit guide, *Audits of Brokers and Dealers in Securities*, at pp. 70-71 (1973):

"In compliance with generally accepted auditing standards, as well as the rules of the Securities and Exchange Commission and the principal national securities exchanges, the independent public accountant is required to review and make appropriate tests of the accounting system, internal accounting control, and procedure for safeguarding securities for the period since the prior examination date. If, based on his review and tests of compliance, no material inadequacies are found to exist with respect to any of the foregoing matters, the independent public accountant should so state in his report on internal control. If, however, material inadequacies are found to exist his report should disclose the nature of the inadequacies and the constructive action proposed to be taken or already taken by the brokerage concern."

the exception thereto shall be specifically and clearly stated. . . ." Moreover, we note that the requirement to disclose a material inadequacy in internal accounting controls, which is at least implicit in Rule 17a-5 and Form X-17A-5, was made explicit by SEC Release No. 8172. As to reports of the financial condition of security brokers and dealers filed as of November 30, 1967 or thereafter, the audit requirements of Form X-17A-5 specifically directed that:

> "Based upon such audit, the accountant shall comment upon any material inadequacies found to exist in the accounting system, the internal accounting control and procedures for safeguarding securities, and shall indicate any corrective action taken or proposed. These comments may be submitted in a supplementary certificate and filed pursuant to Rule 17a-5(b)(3)."

Accordingly, under the circumstances, a finding of a breach of duty of inquiry requires a corollary finding of a breach of duty of disclosure.

VIII

The last element in plaintiffs' claim for aiding and abetting a Rule 10b-5 violation is proof of a causal connection between the breach of the duty of inquiry and disclosure and the facilitation of the underlying fraud. To that end it must be demonstrated that adequate inquiry and subsequent disclosure on Ernst & Ernst's part would have led to the discovery or prevention of Nay's fraud.

Ernst & Ernst contends that plaintiffs would not be able to prove at trial a causal connection. It is urged that plaintiffs' theory of causation rests on utter speculation. On the state of the limited evidence before us and without passing on the extent of the weight and probative value of that evidence, it would not appear to be entirely outside of the realm of reasonableness for the fact finder to infer that adequate inquiry by Ernst & Ernst might not of itself have led to the discovery or prevention of Nay's

fraud.[21] Moreover, with regard to the question of whether adequate disclosure by Ernst & Ernst of a material inadequacy in internal accounting controls would have precipitated action by the SEC or self-regulatory organizations leading to the discovery or prevention of Nay's fraud, we are inclined to the view that this is a matter properly left to full evidentiary development at trial and not disposable on a motion for summary judgment.

IX

In accordance with generally accepted auditing standards, the basic audit procedure to determine the accuracy and correctness of the books and records of a broker or dealer in securities with respect to his customers' accounts is to request and obtain written confirmation from the customers with regard to their accounts. Specifically, the audit requirements of Form X-17A-5 directed the auditor to obtain written confirmation from customers of their accounts.[22]

---

[21] As we noted earlier, plaintiffs' affiants stated that at a minimum they would have made further investigation with respect to the mail rule to assure that it was not the vehicle for irregularity and, absent a satisfactory answer to such inquiry, would have withdrawn from the audit engagement or declined to issue an opinion on the financial position of First Securities.

[22] The audit requirements of Form X-17A-5 prescribed that as of the audit date the independent public accountant was to:

> "(6) Obtain written confirmations with respect to the following (see note):
>
> ". . . .
>
> "(f) Customers', partners', officers', directors', and respondent's accounts. Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of money balances, securities and/or commodities positions, and open contractual commitments (other than uncleared 'regular way' purchases and sales of securities) accompanying the first request for confirmation mailed by the

Pursuant to these requirements, Ernst & Ernst mailed to some of the plaintiffs confirmation forms requesting that they verify the accuracy of the details stated in the confirmation forms as to the amount and composition of the customer's account. The confirmation expressly indicated that the customer was to note any differences and exceptions.[23] Admittedly, no confirmation of account sent by Ernst & Ernst to the plaintiffs at any time listed or referred to plaintiffs' escrow accounts. It is equally clear, however, that no plaintiff who received a confirmation request from Ernst & Ernst took exception to the failure of the confirmation to list his escrow account. On the basis of plaintiffs' failure to take exception to the confirmation requests, the trial judge held that they were estopped as a matter of law from pursuing their claims against Ernst & Ernst. The judge observed:

> "Plaintiffs raise no factual issue that they failed to correct defendant's confirmation slips on their First

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[22] (Continued)

> independent public accountant. Customers' accounts without balances, position or commitments, and accounts closed since the last prior audit shall be confirmed on a test basis.
>
> "*Note*: Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests, together with such auditing procedures as may be necessary; provided, however, that with respect to customers' accounts closed since the last prior audit the accountant may use either positive or negative confirmation request. . . ."

[23] The confirmations were sometimes prepared in the following form:

[23] (Continued)

EXHIBIT L

[illegible] AUDIT CONFIRMATION

[illegible]
[illegible]
[illegible], Illinois

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS October 31, 1967 WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,

FIRST SECURITIES COMPANY OF CHICAGO

SECURITIES LONG

1CH U.S. Treasury Bills 1/11/68

THIS CONFIRMATION REQUEST DOES NOT INCLUDE PURCHASES AND SALES OF SECURITIES, IF ANY, DURING THE FOUR BUSINESS DAYS PRECEDING THE AUDIT DATE.

THE LONG SECURITIES SHOWN HEREON, IF ANY, INCLUDE THOSE HELD IN SAFEKEEPING

CUSTOMERS' CREDIT BALANCES ARE PROPERLY ACCOUNTED FOR ON OUR BOOKS, ARE NOT SEGREGATED, MAY BE USED IN THE OPERATION OF THIS FIRM'S BUSINESS AND ARE PAYABLE UPON DEMAND.

BALANCE { DEBIT ____ CREDIT $101.91

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED. Theresa W. Rothermel

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO. [illegible]

[23] (Continued)

EXHIBIT A

AUDIT CONFIRMATION

Helen C. Allison
5816 S. Blackstone Avenue
Chicago, Illinois 60637

FOR THE PURPOSE OF ASSISTING OUR AUDITORS IN MAKING THEIR REGULAR EXAMINATION OF OUR ACCOUNTS AT THE CLOSE OF BUSINESS SEP [illegible] WE WOULD APPRECIATE YOUR VERIFYING THE POSITION OF THE SECURITIES AND THE BALANCE IN YOUR ACCOUNT, AS SHOWN BELOW.

VERY TRULY YOURS,
FIRST SECURITIES CO. OF CHICAGO
134 S. [illegible]
CHICAGO [illegible]

SECURITIES LONG

NO SECURITY POSITION

THIS CONFIRMATION REQUEST DOES NOT INCLUDE PURCHASES AND SALES OF SECURITIES, IF ANY, DURING THE FOUR BUSINESS DAYS PRECEDING THE AUDIT DATE.

BALANCE { DEBIT -0- CREDIT -0-

PLEASE SIGN THIS CONFIRMATION, NOTING DIFFERENCES IF ANY, AND MAIL IT DIRECTLY TO ERNST & ERNST, 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS, 60604, IN THE ENCLOSED ENVELOPE. YOUR PROMPT COMPLIANCE WILL BE APPRECIATED AND WILL AVOID THE NECESSITY OF FURTHER CORRESPONDENCE.

THE ABOVE STATEMENT OF MY (OUR) ACCOUNT IS CORRECT.

SIGNED. Helen C. Allison

IMPORTANT NOTE
In the case of joint accounts, confirmations should be signed by both individuals. Confirmations signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all confirmations should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

NO. [illegible]

BEST COPY AVAILABLE

[23] (Continued)

Often the confirmation requests were composed so as to elicit the following type of response:

ERNST & ERNST
231 SO. LA SALLE STREET
CHICAGO 4, ILL.

No. C 92

THE STATEMENT OF MY ACCOUNT WITH

FIRST SECURITIES COMPANY
OF CHICAGO

AT THE CLOSE OF BUSINESS DEC 31 1961

IS CORRECT.

(SIGNED) John M. Jackson

IF THE ENCLOSED STATEMENT IS NOT CORRECT, KINDLY INDICATE EXCEPTIONS ON REVERSE SIDE OF THIS CARD.

In the case of joint accounts, cards should be signed by both individuals. Cards signed by banks, corporations and partnerships should bear the name of the institution as well as the signature of authorized officer or partner. In the case of individuals, all cards should be signed by the person in whose name the account is carried. Observance of the above conditions will eliminate the necessity of further correspondence on account of incorrect signatures.

Securities accounts, and it was only with respect to auditing First Securities Co. that defendant Ernst & Ernst had any responsibility. Therefore in the only direct dealings which plaintiffs had with this defendant, they misled defendant to its detriment in a very material respect. Had they not done so, we might infer that Ernst & Ernst would have been put on notice sufficiently to investigate further and perhaps perfect its audit, but its failure to do so was caused in part by the plaintiffs, for aught that appears in the record."

Estoppel is properly asserted as an affirmative defense to a claim of aiding and abetting a Rule 10b-5 violation. See generally, *Straley* v. *Universal Uranium and Milling Corp.*, 289 F. 2d 370 (9th Cir. 1961); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 213-14 (9th Cir. 1962); *Dale* v. *Rosenfeld*, 229 F.2d 855, 859 (2d Cir. 1956). It is a rule of fundamental fairness whereby a party is precluded from benefiting from his own inconsistent conduct which has induced reliance to the detriment of another. That is, where a plaintiff has, with knowledge of the facts, initially conducted himself in a particular fashion, he cannot thereafter assume a posture inconsistent with such conduct to the detriment of a defendant who has acted in material reliance upon that conduct. See, *e.g.*, *Hecht* v. *Harris, Upham & Co.*, 430 F. 2d 1202, 1208 (9th Cir. 1970); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 212-14 (9th Cir. 1962); *Hampton* v. *Paramount Pictures Corp.*, 279 F. 2d 100, 104 (9th Cir. 1960). Applying the estoppel rule to the instant case, if plaintiffs knew they were to report the escrow accounts as an exception on the confirmation and failed to do so, they ought not be heard to complain of Ernst & Ernst's failure to uncover or prevent the fraudulent escrow scheme, for the inference is strong that disclosure by plaintiffs to Ernst & Ernst of the existence of the escrow accounts would have led to the discovery of Nay's fraudulent scheme. Whether plaintiffs knew or as reasonable persons should have known that they were to report the escrow accounts as exceptions on

the confirmation requests is a question to be properly decided by the fact finder. We cannot say as a matter of law that a reasonable investor of similar business sophistication and intelligence as plaintiffs would have reached no other conclusion but that disclosure of the escrow account was called for by the confirmation request. Nor can we conclude that a reasonable investor viewing the express language of the confirmation would have limited his verification to the amounts stated and noted no exceptions for the escrow account.[24]

X

The trial judge held that the applicable three year statute of limitations had run in view of the fact that Ernst & Ernst's last audit was filed in December, 1967 and the first complaint in plaintiffs' actions were not entered until February, 1971. In the district court plaintiffs urged that the equitable tolling doctrine prevented the bar of the statute of limitations from beginning to run until Nay's fraud was discovered shortly after his suicide in June, 1968, and, on that basis, it can be stated that plaintiffs' position refutes any claim that their actions were untimely filed. The trial judge rejected the plaintiffs' effort to invoke the equitable tolling doctrine, holding that "the cause of action was not fraudulently concealed by this defendant." Assuming the applicability of the tolling doctrine, the judge went on to note that the plaintiffs could not demonstrate due care on their part in light of their failure to come to the knowledge of the wrong of which they complained.

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[24] As to those plaintiffs to whom Ernst & Ernst sent no confirmations we find the estoppel argument to be unavailing. It cannot be said that Ernst & Ernst relied on any direct action or express representation by such plaintiffs. Nor can Ernst & Ernst ground its estoppel defense on any alleged representation emanating from transaction confirmations sent to plaintiffs by First Securities and not sent by Ernst & Ernst in the course of its audit.

We have addressed this same issue in the companion case to the instant action. *Hochfelder, et al. and Martin, et al.* v. *Midwest Stock Exchange,* Nos. 72-1977, 72-1978 (April 10, 1974). In that decision we observed that the "equitable tolling doctrine provides that where a fraud which is the foundation of the suit has actively been concealed or is of such a nature as to conceal itself, the statute of limitations is tolled until the plaintiff has obtained knowledge of the fraud or in the exercise of due care should have obtained knowledge of the fraud. *Bailey* v. *Glover,* 88 U.S. (21 Wall.) 342, 349 (1874); *Holmberg* v. *Armbrecht,* 327 U.S. 392, 396 (1945); *Morgan* v. *Koch,* 419 F. 2d 993, 997 (7th Cir. 1969)." We went on to note that the thrust of plaintiffs' action against the Midwest Stock Exchange, as here against Ernst & Ernst, was grounded in negligence and not on any contention that the defendant was chargeable with acts of fraud or fraudulent concealment. In rejecting the defendant's assertion that the tolling doctrine did not embrace the plaintiffs' action we stated:

". . . However, we do not believe that the tolling doctrine should be so narrowly drawn that it does not encompass Midwest's alleged acts of facilitation of the fraud.

"It is charged that Midwest's conduct amounted to negligence and that its negligence facilitated or provided the means for Nay's fraud. Nay effectively concealed his fraud and as a result the alleged implementing negligence of Midwest was concealed and brought to the surface only when the facts surrounding Nay's fraud were first discovered. If claims brought in the same posture as the instant action—asserting charges amounting to negligence but short of fraud—are to have any vitality it cannot be contended that the tolling doctrine should not apply. Often the underlying fraud, carefully concealed in and of itself, would cloak the implementing actions of others. Accordingly, where the acts of a defendant facilitate the perpetration of a concealed fraud of

another, the bar of the statute of limitations should not begin to run until a plaintiff obtains knowledge or through due diligence should have obtained knowledge of the underlying fraud."

This observation is applicable in the instant action for Ernst & Ernst is charged with the negligent facilitation and implementation of Nay's fraud. Moreover, Nay through his efforts in concealing the underlying fraud effectively cloaked and concealed the alleged negligent facilitating conduct of Ernst & Ernst. In our judgment plaintiffs may avail themselves of the equitable tolling doctrine and the bar of the statute of limitations does not begin to run until it can otherwise be established that they knew or in the exercise of due diligence should have known of Nay's fraud. Whether plaintiffs knew or in the exercise of due diligence should have known of Nay's fraud is, on the basis of the evidence before us, an issue properly to be **decided at a trial.**

The judgment of the district court is reversed and the case is remanded for trial under the provisions of Circuit Rule 23.

APPENDIX B

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

Olga Hochfelder, Theresa W. Rothermel, Agnes Smith, Eugene Viota, Helen B. Feldkamp, Anna L. Jesse, William B. Jesse, Eric W. Stubbs, Lurenta T. Stubbs, Zerah A. Drake, John M. Jackson, Individually and Elizabeth B. Jackson, *Plaintiffs,* v. Midwest Stock Exchange and Ernst & Ernst, *Defendants.*	No. 71 C 454
Leon S. Martin and L. Stanbridge Martin, *Plaintiffs,* v. Midwest Stock Exchange and Ernst & Ernst, *Defendants.*	No. 71 C 1204

(August 1, 1973)

DECISION ON DEFENDANT'S ERNST & ERNST'S MOTION FOR SUMMARY JUDGMENT

These cases come on to be heard in their final stage on the motion for summary judgment of Ernst & Ernst, the accountants who audited First Securities Company of Chicago on behalf of the defendant Midwest Stock Ex-

change. All other issues and claims have been disposed of, partly in prior litigation (463 F.2d 981 and 466 F.2d 1035 (7th Cir. 1972), *cert. den.*), and partly by prior rulings in the cases at bar. In particular, Midwest Stock Exchange's Motion for Summary Judgment has been granted. We now find and conclude that defendant Ernst & Ernst is entitled to a judgment on its behalf as a matter of law.

The first ground for this decision is that the Illinois three-year statute of limitations began to run in favor of this defendant when defendant filed its last audit in December 1967. The Complaint was not filed until February 19, 1971, and the cause of action was not fraudulently concealed by this defendant. The concealment by Nay or First Securities Company is irrelevant, since they were not agents of Ernst & Ernst and were not aided or abetted by Ernst & Ernst. Cf. *Lanza, et al.* v. *Drexel & Co., et al.*, ... F.2d ..... (2d Cir., #35794, April 26, 1973).

Under *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), the statute is tolled if a plaintiff fails to discover the wrong "without any fault or want of diligence or care on his part" (455 F.2d at 128). In the case at bar, however, plaintiffs do not dispute the fact that they allowed Nay to conduct his improper activities and to conceal them from the defendant in various ways. Without denial, defendant has shown that plaintiffs made their investments in the form of checks payable to Nay individually, that they told the Internal Revenue Service as late as 1965 that Nay was paying interest to them on his personal indebtedness to them, and that they inaccurately confirmed their accounts at First Securities Company when requested by defendant to verify them. Thus plaintiffs not only did not exercise diligence or care to discover Ernst & Ernst's alleged negligence but they actively participated in causing this defendant's failure to discover the fraud when it audited First Securities Co. in 1967 and before. Acc. *Morgan* v. *Koch*, 419 F.2d 993 (7th Cir. 1969).

For much the same reasons, the defense of estoppel is available to Ernst & Ernst as a matter of law. *Hecht* v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); see also *Holmberg* v. *Armbrecht*, 327 U.S. 392, 396-7 (1946). Plaintiffs raise no factual issue that they failed to correct defendant's confirmation slips on their First Securities accounts, and it was only with respect to auditing First Securities Co. that defendant Ernst & Ernst had any responsibility. Therefore in the only direct dealings which plaintiffs had with this defendant, they misled defendant to its detriment in a very material respect. Had they not done so, we might infer that Ernst & Ernst would have been put on notice sufficiently to investigate further and perhaps perfect its audit, but its failure to do so was caused in part by the plaintiffs, for aught that appears in the record.

If plaintiffs' claims were not precluded by one or both of the foregoing defenses, we would reach the merits. Plaintiffs allege that defendant Ernst & Ernst failed in its auditing duties of First Securities Co. in several specific respects which can be summarized from the First Amended Complaint as follows: (a) to ascertain on behalf of the Midwest Stock Exchange that its member Nay was a person with a high standard of commercial honor and integrity; (b) to ascertain that Nay, as an officer of First Securities Co., took regular vacations so that his duties were performed at such times by other employees; (c) that mail addressed to First Securities Co. for Nay's attention was not opened in Nay's absence and thus that First Securities Co. had no adequate or proper accounting control; (d) Nay's failure to take regular vacations and his order that mail addressed to his attention not be opened in his absence violated Section 27(c) of the Rules of Fair Practice of the National Association of Securities Dealers; (e) Ernst & Ernst failed to report the foregoing violations in answering the Midwest Stock Exchange's questionnaire regarding the internal accounting control of First Securities Company.

The substance of these charges is that Ernst & Ernst failed to discover and report the violations by Nay and First Securities Co. of Section 27(c) of the National Association of Securities Dealers' Rules of Fair Practice. Defendant in auditing First Securities Company contends that it followed generally accepted accounting procedures as they existed in 1967 and before, by relying on N.A.S.D.'s examination and enforcement of its own rules. Defendant contends that it is not responsible for any oversight by N.A.S.D. in this respect, regardless of the fact that Nay and First Securities Company did violate N.A.S.D.'s Rules of Fair Practice (as was held by the Court of Appeals at 463 F.2d 986 and 988).

Plaintiffs rely on affidavits of Messrs. Gorst, Mayer and Duncombe attached to their Memorandum. The first-named individual was a National Bank Examiner whose statement refers only to bank examinations. The latter two attest to general auditing procedures, including audits of securities dealers. They state that, as part of evaluating internal controls, it is significant to determine that no single individual handles the receipt as well as the recording of a transaction. The scheduling of regular vacations so that other members of the organization would handle the duties of that person is a significant internal control mechanism, and the failure to check this fact is an auditing failure, according to these two affiants.

These two affiants conclude that, if they had known of Nay's violation of N.A.S.D.'s Rule 27(c), they would not have certified an audit. However, plaintiffs have not established in the record that these alleged practices existed at First Securities Company, during the periods of defendant's audits. Nor have they established that, according to generally accepted accounting practices as they existed in the securities industry in 1967 and before, these conditions should have been discovered by the defendant as distinguished from the N.A.S.D. The defendant's evidence is that the accounting practices were consistently to the contrary.

Defendant's affidavit of Roy E. Campbell, who was cashier and office manager of First Securities Co., states unequivocably that Nay took vacations every year and that his practices in this respect were similar to that of the other officers of the company. Plaintiffs' affidavits on this subject are based on hearsay or speculation. Campbell further states that Nay did not approve confirmation tickets of transactions which he himself had handled for a customer and did not ordinarily handle stock certificates or cash. He also states that Nay and all other employees of the company customarily opened mail addressed to their attention but that Nay was the only one who insisted that such mail be held unopened in his absence. There is no evidence that any company mail addressed to Nay's personal attention contained any information which would have led to discovery of his fraud, and mail addressed to him individually would not be involved in an audit of the company. In short, the evidence in the record shows without dispute that Nay and the plaintiffs insulated First Securities Company from his fraud, and that Nay undoubtedly did this for the purpose of concealing it from the defendants, the N.A.S.D., and the Securities Exchange Commission.

It should be noted that First Securities Company has been held liable for Nay's activities on various legal theories (463 F.2d 981 as summarized at 466 F.2d 1038), none of which reach to the defendant in this case. Furthermore we must decide the defendant's motion on the facts and law presented herein. There is no evidence in the record of this case that First Securities Company committed any fraud or indeed even committed any breach of acceptable control practices, and it follows that there is no genuine issue of fact concerning defendant's failure to discover this.

The parties have raised other subsidiary issues of law which can be decided premptorily. We find and conclude that defendant could be held liable on one or more legal theories for any negligence in auditing First Securities

Company, and we would not grant defendant's motion for summary judgment on the ground of non-liability merely because plaintiffs are not suing as customers of First Securities. Since plaintiffs have failed to present a genuine issue of material fact with respect to defendant's negligence, however, we alternatively find in favor of defendant Ernst & Ernst on the merits.

It is therefore ordered, adjudged and decreed that judgment be and it is entered in behalf of the defendant Ernst & Ernst on the First Amended Complaint in both of the above-entitled cases.

Enter:
/s/ Thomas R. McMillen
Judge, U.S. District Court

APPENDIX C

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604
November 22, 1974
Before
Hon. Luther M. Swygert, Chief Judge
Hon. Latham Castle, Sr., Circuit Judge
Hon. Robert A. Sprecher, Circuit Judge

Olga Hochfelder, Leon S. Martin, et al., Plaintiffs-Appellants, No. 73-1907, 73-1908 vs. Midwest Stock Exchange, et al., Defendants-Appellees.	Appeal from the United States District Court for the Northern District of Illinois, Eastern Divsn. (71 C 454) (71 C 1204)

On consideration of the petition for rehearing filed in the above-entitled cause,

It Is Hereby Ordered that the petition for rehearing in the above-entitled appeal be, and the same is hereby, Denied.

APPENDIX D

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 under the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.